

November 22, 2011

## Here's What We're Thinking

The Investment Committee of the Portfolio Advisory Group meets weekly to formally discuss markets, sector allocation and investment recommendations. Below is a brief synopsis of our current market view.

- If investors were able to consider in isolation recent U.S. economic statistics, corporate earnings, improving profit margins and strong balance sheets, all collectively known as “fundamental data”, current stock prices would be seen as exceedingly attractive; regrettably, in the current environment, fundamentals continue to be superseded by macro concerns.
- Although fundamentals will matter eventually, our cautious outlook remains the same for now from a trading perspective.
- Canadian and U.S. equity markets may extend the recent downward move (down 6%-8% over the past two weeks), but market technicals suggest investors be prepared to add equity exposure should we experience another 5%+ decline.
- Global equities continued their decline last week on further contagion fears posed by the European debt crisis and the implications for the global banking system.
- Although the ECB (European Central Bank) has intervened by buying government bonds of weak members Italy, Spain, and Portugal, failure by senior members Germany and France to agree on the ultimate role of the ECB as backstop for the European Union has capital markets remaining anxious. Agreement by Germany on a bailout is not likely forthcoming until they are forced by a severe crisis, not just the threat of one.
- Following the positive news last week of a new pro-austerity government in Italy, Spain elected a majority conservative government on the weekend yet Spanish bond yields still traded at record highs yesterday.
- And despite the failure of the so-called U.S. Congressional “super committee” to reach agreement yesterday on US\$1.2 trillion in budget cuts, the U.S. dollar and U.S. treasury bonds remain the safe-haven of preference for global investors, pushing U.S. bond yields lower.
- The absence of an agreement by the super committee leads to automatic spending cuts of US\$1.2 trillion over 10 years starting in 2013, half of which will come from the Defense budget. Although supposedly “automatic”, expect the political jockeying to continue over efforts to block cuts, particularly as rhetoric heats up during the upcoming U.S. presidential election year.
- Given this backdrop, investors are showing little appetite for risk and becoming increasingly guarded, evidenced by continued equity and high yield bond selling. Cash positions for both institutional and retail investors are near record levels.
- For fixed income exposure, the current low rate environment offers little value in the mid to long end of the curve and we recommend investors remain short duration at this time. From a sector weighting perspective, investors should be underweight Canada’s and overweight provincials, municipals and corporates. The recent narrowing of high yield spreads leaves us at a point of indifference on these credits. With the Canadian dollar expected to outperform most major currencies over the coming year, we recommend Canadian investors remain in Canadian dollars for their fixed income holdings.
- Although the trend has been down for equities, it should be noted that declines have been on relatively light trading volumes, implying a lack of conviction by investors. Volumes are expected to be particularly light this week as the U.S. effectively shuts down for the week in anticipation of their Thanksgiving holiday.
- We expect equity market volatility to continue and recommend selective profit taking as stocks are trading near the upper end of the trading band established over the past several months. **For buyers building longer term portfolio positions, we expect the market will provide a better entry point so there is no rush to buy at current levels.**
- One of a few exceptions would be gold which technically looks very attractive. Both gold bullion and gold equities should perform well in the current environment.
- Commodity cyclicals and industrial stocks offer the most upside potential in the event equities rally again, but they also will likely continue to exhibit the greatest volatility.
- Many high quality dividend paying stocks at current levels do not offer much capital appreciation potential but will provide investors with the most downside protection if the market retreats; and the steady dividend income generated remains an important component in portfolio total returns.
- Given our outlook for an extended period of slow economic growth, whether falling into outright recession in North America or not, equities are expected to trade in a range for the next several years.

For more information on how these ideas pertain to your investment portfolio, please contact your ScotiaMcLeod advisor.

Summarized by **Steve Uzielli** - Director, Portfolio Advisory Group

## PAG Report

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